

May 13, 2005

Mr. David Ikari., Chief
Dairy Marketing
California Department of Food and Agriculture
1220 N Street
Sacramento, California 95814

Dear Mr. Ikari:

This post hearing brief is submitted on behalf of Land O' Lakes for the hearings held in Ontario on May 6, 2005 on the subject of the Class 1 prices in California. This brief amplifies the testimony presented in May 6, 2005 and responding in part to other testimony presented by others.

1. As mentioned in the testimony on May 6, 2005 it is important to repeat the call of the hearing which stated in part, "Additionally, because any change in the relative Class 1 prices between Northern and Southern California affects the ability of processors to move milk plant-to-plant, the hearings will consider amendments to the Transportation Credits, but only to the extent that there are changes to the relative Class 1 prices". This statement in the call of the hearing says that if the relative Class 1 prices are unchanged, there will be no adjustment in the transportation credits. This is clearly a case where Land O' Lakes can lose but it there is no way where Land O' Lakes can win. We consider this statement in the call of the hearing one which essentially considers that the milk movement incentive plant-to-plant will remain unchanged. Any other interpretation just makes no sense. This was supposed to be a Class 1 price hearing and not a hearing could change the relative economics of moving milk either on a ranch to plant basis or on a plant-to-plant basis. We did not prepare ourselves for a transportation credit hearing and we find ourselves in a disadvantaged position due to testimony that was received by the CDFA panel, without comment even though, we consider part of that testimony to be outside the call of the hearing. As stated in formal testimony on May 6th, the testimony by Western United Dairymen and as stated in the post hearing brief for the May 3rd hearing, parts of Western United Dairymen should be ignored.
2. Mr. Korsmeier of California Dairies, Inc. and representing the Alliance of Western Milk Producers stated that he favored an adjustment in the transportation credit to offset any adjustment in the Area Differential as a part of this hearing. Of course, that is Land O' Lakes position as well.
3. It was not our intention to revisit any of the documents having to do with the Milk Movement Hearing held in August 2004; but, when Western United Dairymen made some reference to it, we decided to look at some of the documents as well. Unfortunately, when preparing for a the milk

movement hearing, we acknowledged the Departmental documents and even referred to some of the documents in our testimony we did not take the time to make a detailed analysis of some of the information. It turns out we should have done so prior to the Milk Movement Hearing but there were other issues to deal with and that included preparation of testimony for a hearing that we considered to be of utmost importance. When studying Exhibit 7d and specifically tables 4 and 5 we discovered some inconsistencies and some inaccuracies in the data. It is not our intention of being critical; but, when some of the information was utilized to make a decision on a very vital issue with Land O' Lakes, namely, plant-to-plant transportation credit issues, we think it is important to discuss some of the inaccuracies contained in tables 4 and 5 in Exhibit 7d. The attached excel document repeats Table 4 in Exhibit 7d. The following were some of the important issues that were found:

- a. The document as published in the Exhibit 7d at the bottom of Table 4 shows assumptions and one of those was that a Class 1 plant receiving ranch to plant milk would have to receive 11,494 pounds of milk to produce a 10,000 pound product containing 2 percent fat and 10 percent solids not fat. A further examination revealed that it would be necessary for a Class 1 plant to receive in excess of 11,828 pounds of milk because excess fat is shipped as cream and cream has 60 percent skim and contains some solids not fat namely about 5.4% solids not fat. What does this mean? The processing costs with respect to cream are understated because the cream pounds are understated and secondly the shipment cost of excess cream is also understated because the pounds are understated in Table 4 of Exhibit 7d.
- b. Table 4, see attached excel report, also shows cream processing costs, condensed skim processing costs and skim processing costs for a Class 1 plant in Riverside California as shown in columns 2 and 3 in table 4. So far as we know there are no documented cost studies by CDFA, at least recent ones, that identify what the costs of processing cream, condensed skim or skim would be for a Class 1 plant anywhere in the state of California including the Riverside Class 1 plant. So the costs associated with columns two and three of Table 4 represent assumptions of costs. There is no way to tell how close these stated costs are to reality.
- c. We reviewed a 2002 Land O' Lakes plant cost study (and this would have been the latest cost study that would have been available for the August 2004 hearing). The costs for processing the 507.1 pounds of cream as shown in column 1 in the attached document (table 4) which would have been generated with the erroneous 11494 pounds of milk that would have been received on a ranch to plant basis is understated by a significant amount. In fact, the cost per pound of cream used in column 1 was \$4/507.1 pounds of cream) or \$.007888 per pound of cream. But, the CDFA

cost study for Land O' Lakes in 2002 revealed that the costs to produce a pound of cream for LOL would have been significantly larger than \$.007888 per pound of cream (again refer to column 1 of the attached table 4). The cost per pound of condensed skim in column 1 of table 4 turned out to be \$9/500 pounds of condensed skim or \$.018 per pound of condensed skim. Again, in referring to the CDFA Land O' Lakes cost study of 2002 revealed that the cost of producing condensed skim was much larger than \$.018 per pound of condensed skim. Finally, the cost per pound of skim used in column 1 was \$18/4000 pounds of skim or \$.0045 per pound of skim. Again, as for the other products, the cost per pound of producing a pound of skim greatly exceeded \$.0045 per pound of skim in column 1 of Table 4 in Exhibit 7d.

4. This discovery was somewhat surprising and disconcerting because this information, in part, was apparently used by the Department to make a decision on the milk movement hearing in August 2004. It is also somewhat troubling to hear a suggestion that the Class 1 plant in Riverside should have been responsible for paying for some or all of the benefits of cost efficiencies because Land O' Lakes delivered a tailored product to the customer. And, as a result, the transportation credit shortfall was not reduced as a result of the August 2004 hearing.
5. It would make little sense for a Class 1 plant to make a major investment in an evaporator or possibly even in a cream separator if it was possible to buy skim and condensed skim from a manufacturing plant like Land O' Lakes in Tulare. Certainly, even if there is a service charge associated with those products it might be prudent for a Class 1 plant in Southern California to do so rather than to incur a major cost disadvantage from receiving milk ranch to plant such as those shown in columns two and three in Tables 4 and 5 in Exhibit 7d. Of course, this scenario could involve Land O' Lakes supplying skim or condensed skim to Class 1 plants in Southern California and this still another reason for adjusting the transportation credits to reflect changes in the cost of the long distance haul. A plant production expert at Land O' Lakes told me that another alternative to making a major investment in an evaporator is for the Class 1 milk plant to purchase a relatively small reverse osmosis unit.
6. Finally, Land O' Lakes had taken the responsibility of serving the Class 1 milk market for many years even though the opportunity cost of doing so was substantial and that was particularly true if the milk had been used to produce butter and powder. We did that because we thought that it was important for a manufacturing unit like ours to not only provide a reserve supply of milk for the Class 1 market but to supply Class 1 plants with milk products even if the profits of LOL were affected adversely. Our producers as well as all producers benefit from the highest valued products in the market and that is the Class 1 market and our producers own quota, some more and some less, but this is one of the reasons we felt it was important to serve the Class 1 deficit market in Southern California. But,

the decision at the last milk movement hearing disrupted a business relationship that lasted more than 40 years. This was a business relationship that involved serving a Class 1 customer with tailored milk. The business relationship was a good one for both parties. But, CDFA made a major policy adjustment and the business relationship that lasted many years was severed. We continue to supply some Class 1 and Class 2 customers but the proportion of Land O' Lakes milk used to supply such customers is now the lowest it has been in history.

7. We did not come into this hearing with the intention of discussing issues of milk movement. We thought this was a Class 1 hearing. And, in my opinion, this is not the venue to discuss milk movement issues as I have done in the past few paragraphs; but, Western United Dairymen testified to the reduction of the compensation for the plant-to-plant milk movement. Some of Western United Dairymen's testimony was outside the call of the hearing. But no one called them on it. And that is why I have re-visited some issues with respect to milk movement. We think it is entirely appropriate to treat this hearing as a Class 1 hearing and not one that changes the relative economics in serving the Class 1 market on a plant-to-plant or on a ranch-to-plant basis. In fact, we strongly believe that this is not the hearing to change the relative economics of serving the Class 1 market with ranch to plant or plant-to-plant milk.

Sincerely,

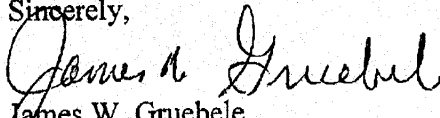

James W. Gruebele
Consultant for Land O' Lakes

EXHIBIT 7D

FROM; BACKGROUND MATERIAL SPECIFIC TO MILK MOVEMENT INCENTIVES
FOR AUGUST 4, 2004 HEARING WITH CORRECTIONS AND ADDITIONS RESULTING
FROM JULY 20, 2004 PRE-HEARING WORKSHOP

TABLE 4. COMPARISON OF EFFICIENCY OF RANCH TO PLANT AND PLANT TO PLANT
MILK MOVEMENT

CURRENT ALLOWANCES AND CREDITS

PLANT TO
PLANT

	Tulare ranch to Tulare plant to So. Calif Plant	Kern Ranch to So. Calif Plant back to Tulare plant	Tulare Ranch to So. Calif Plant back to Tulare plant
ranch to plant haul	\$29	\$85	\$112
plant to plant haul	\$102	\$4	\$4
cream processing	\$4	\$14	\$14
cond skim processing	\$9	\$17	\$17
skim processing	\$18	\$86	\$86
total	\$162	\$206	\$233
less trans allowance		\$49	\$67
less trans credit	95		
net	\$67	\$157	\$166

assumptions:

11494 pounds of 3.5%, 8.7% ranch milk

10,000 pounds of 2%, 10% plant milk

2%, 10% milk from 55% ranch milk (8.5,8.7) 40% skim (0,9.0) and 5% condensed skim (.4, 32.0)

whole milk	3.50%	8.70%	55.00%
skim milk	0.12%	9.00%	40.00%
condensed skim	0.43%	32.00%	5.00%
2-10 milk	1.99%	9.99%	100.00%

what are some problem areas in this analysis?

assumption of 11494 pounds of ranch milk

for 10,000 pounds of milk you need 199.45 pounds of fat and 999.9757 pounds of solids not fat

	# of milk	fat #		snf pounds
pounds of milk	11494	0.035	402.29	0.087 999.978
need fat			199.45	
surplus fat pounds			202.84	
fat percentage in cream			0.4	
cream pounds			507.1	
but cream has 5.4% snf in it so you lose it when you ship it to tulare for processing			507.1	0.054 27.3834
residual solids not fat				972.5946

the problem is with 11494 pounds of milk you end up with only 972 pounds of solids not fat but the requirement is approximately 1000 pounds with 10,000 pounds of 2-10 milk

How much ranch to plant to milk do you need? The answer is 11826.8 pounds

	# of milk	fat #		snf pounds
	11826.8	0.035	413.938	0.087 1028.932
need fat			199.45	
surplus fat pounds			214.488	
fat percentage in cream			0.4	
cream pounds			536.22	
but cream has 5.4% snf in it so you lose it when you ship it to tulare for processing			536.22	0.054 28.95588
residual solids not fat				999.9757

With 11826.8 pounds of ranch to plant milk when you get rid of extra fat by converting it to cream and sending it to Tulare you have enough solids not fat to meet 2-10 requirement

Of course, these additional pounds of cream would affect cost of processing, also it would change the cost of shipping cream back to Tulare.

What other problems are there with Table 4 in Exhibit 7d in 2004 Milk Movement Hearing?

So far as I know, CDFA has not made recent cost studies in fluid milk processing operations.

So far as I know, I have not seen any documented costs of separating cream, of making condensed skim or skim in a fluid milk processing plant. It looks like that there are assumptions made about how much it costs a fluid operation to make cream, condensed skim and skim from ranch to plant milk to make the milk product with 2% fat and 10% solids not fat. see columns 2 and 3 of table 4 on first page of excell worksheet

In addition I used the 2002 cost study for Land O' Lakes and found that the costs of processing cream, condensed skim and skim were seriously understated for the Tulare operation.

Even when processing only 507.1 pounds of cream which was in error, the processing costs far exceed \$4.

The study assumed that there would be 500 pounds of condensed skim needed to produce a 2% and 10% milk product (5% times 10,000 pounds) and the costs for making 500 pounds of condensed skim is substantially more than \$9 which was reported in Table 4 of Exhibit 7d.

Table 4 assumed there would be 4000 pounds of skim needed to produce a 2% and 10% milk product (40% times 10,000 pounds) and the costs of making 4000 pounds of skim is substantially more than \$18 which was reported in Table 4 of Exhibit 7d when using CDFA Land O' Lakes plant costs for 2002.

It turns out that the processing costs per pound of cream for Tulare were stated as follows

	total cost	pounds	cost per pound
cream	\$4.00	507.1	0.007887991
condensed skim	\$9.00	500	0.018
skim	\$18.00	4000	0.0045

The per pound cost of making cream, condensed skim and skim is greatly understated based upon the CDFA cost study for LOL plant in 2002